[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX PROPOSALS RELATING TO DOMESTIC OIL AND GAS PRODUCTION AND ENERGY SECURITY

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

OF THE

SENATE COMMITTEE ON FINANCE

ON JUNE 5, 1987

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JUNE 4, 1987

U.S. GOVERNMENT PRINTING OFFICE

73-667 WASHINGTON : 1987 JCS-14-87

J862-22
S362-13

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

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INTRODUCTION

The Senate Finance Subcommittee on Energy and Agricultural Taxation has scheduled a public hearing on June 5, 1987, on five energy-related tax proposals: (1) S. 200 and S. 255 (repeal of the crude oil windfall profit tax); (2) S. 233 (primarily relating to oil and gas income tax provisions); (3) S. 846 (provisions relating to oil and gas income taxation and repeal of the crude oil windfall profit tax); (4) tax incentive options contained in the Department of Energy report on energy security, March, 1987; [1] and (5) recommendations for tax legislation contained in the President's May 6, 1987 message to the Congress on energy and national security concerns related to oil import levels.

The first part of the pamphlet [2] is a summary of the proposals. The second part is a description of the proposals by subject area, including present law, explanation of the proposal, and analysis of selected issues.

[1] United States Department of Energy, *Energy Security: A Report to the President of the United States*, March, 1987.

[2] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Proposals Relating to Domestic Oil and Gas Production and Energy Security* (JCS-14-87), June 4, 1987.

I. SUMMARY

A. S. 200—Senators Nickles, Bentsen, Dole, Wallop, and others; and S. 255—Senators Boren and Bingaman

Repeal of Crude Oil Windfall Profit Tax

Present law imposes an excise tax (the crude oil windfall profit tax) on the windfall profit element of domestically produced crude oil. The tax is scheduled to phase out over a 33-month period beginning in January 1991, or earlier if revenues exceed a specified amount.

The bills (S. 200 and S. 255) would repeal the crude oil windfall profit tax. S. 200 would be effective for oil removed after December 31, 1986, and S. 255 would be effective for oil removed after the date of enactment.

B. S. 233—Senators Boren, Bingaman, Nickles, and Wallop

Income Tax Amendments Related to Domestic Oil and Gas Production

This bill would provide additional income tax incentives for domestic oil and gas production. Among these, the bill would increase the percentage depletion rate if the taxpayer's average removal price for crude oil is less than $20 per barrel, repeal the 50 percent of net income limitation on percentage depletion, and allow transferred properties to qualify for percentage depletion. (A similar anti-transfer rule also would be repealed for windfall profit tax purposes.) The bill also would eliminate recapture of intangible drilling and development costs ("IDCs") upon disposition of an oil, gas or geothermal property, and treat geological and geophysical ("G&G") costs and surface casing costs as expensible IDCs.

These provisions generally would be effective on the date of enactment, except that the increase in the percentage depletion rate (if applicable) would be effective for calendar years beginning after 1986.

C. S. 846—Senators Nickles and Wallop

Energy Security Act of 1987

This bill would repeal the crude oil windfall profit tax and, additionally, provide further income tax incentives for domestic oil and gas production. Among these, the bill would allow percentage depletion at a 27.5-percent rate for domestic new, enhanced, and stripper production (whether or not held by an independent producer or royalty owner); increase the net income limitation on percentage depletion, from 50 to 100 percent; and allow transferred properties to qualify for percentage depletion. (Transferred proper-

ties could also qualify for the independent producer stripper well exception to the windfall profit tax.) The bill further would treat G&G costs as expensible IDCs, and would exclude IDCs from the list of preference items for purposes of the alternative minimum tax. Finally, the bill would apply a 3-year statute of limitations on windfall profit tax assessments in certain cases of underwithholding of tax, where the producer did not file a required tax return.

These provisions generally would be effective on the date of enactment. The allowance of percentage depletion for domestic new, enhanced, and stripper production would apply to production during the taxpayer's first full taxable quarter after the date of enactment.

D. Department of Energy Report

The March 1987 Department of Energy report on energy security ("DOE report") provides a comprehensive analysis of the world and domestic energy outlook, and evaluates various tax and other options for addressing energy security concerns. Tax incentives discussed in the DOE report include repeal of the crude oil windfall profit tax; an increase in the percentage depletion rate from 15 to 27.5 percent, either for independent producers and royalty owners (as under present law) or for all new domestic production; an increase in the net income limitation, from 50 to 100 percent; repeal of the percentage depletion anti-transfer rules; treatment of G&G costs as expensible IDCs; and a 5-percent income tax credit, either (1) for all drilling and exploration costs or (2) for G&G expenditures only. The report assesses the advantages and disadvantages associated with each of these options and estimates the revenue loss, as well as the increased oil and gas production, likely to result from each option; however, it does not specifically recommend any option.

E. President's Proposal

In a message to the Congress on May 6, 1987 (the "President's proposal"),[3] President Reagan made three recommendations for tax legislation to strengthen the domestic oil industry. The President's tax proposals include: (1) repealing the crude oil windfall profit tax, effective October 1, 1987 (also included in the President's FY 1988 Budget); (2) increasing the net income limitation on percentage depletion, from 50 to 100 percent of net income from the property; and (3) allowing transferred property to qualify for percentage depletion. The message also proposed various non-tax measures.

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[3] This message was sent to the Congress pursuant to section 3102 of the Consolidated Omnibus Reconciliation Act of 1986 (P.L. 99-509), which directed the President to transmit his views of legislative and/or administrative action necessary to prevent imports of crude oil and petroleum products from exceeding a level that threatens national security. The Department of Energy report (summarized in D., above), which preceded the President's message, also was prepared pursuant to the requirements of P.L. 99-509.

II. DESCRIPTION OF PROPOSALS

A. Crude Oil Windfall Profit Tax Proposals

1. Repeal of crude oil windfall profit tax

Present Law

Present law (Code secs. 4986-4998) imposes an excise tax (the crude oil windfall profit tax) on the windfall profit element of the price of domestically produced crude oil when it is removed from the premises on which it was produced. Generally, the windfall profit element is defined as the excess of the sale price over the sum of the adjusted base price plus the applicable state severance tax adjustment. The windfall profit element may not exceed 90 percent of net income attributable to a barrel of crude oil.

The tax rates and recent base prices applicable to taxable crude oil are as follows:

Category of oil	Tax rate (percent)	Estimated base price [1] (dollars per barrel)
Tier-1 Oil (oil not in tiers 2 or 3):		
Integrated producer	70	$18.85
Independent producer	50	19.44
Tier-2 Oil (Stripper and Petroleum Reserve oil):		
Integrated producer	60	21.29
Independent producer	30	NA
Tier-3 Oil:		
Newly discovered oil	[2] 22.5	28.54
Incremental tertiary oil	30	28.07
Heavy oil	30	23.91

[1] Estimate for third quarter of 1987 based on *SOI Bulletin* (Summer 1986). Tier-1 oil excludes North Slope oil.

[2] Phases down to 20 percent in 1988 and 15 percent in 1989 and subsequent years.

Independent producer stripper well oil is exempt from the tax. Additionally, crude oil from a qualified governmental or a qualified charitable interest, certain front-end oil, certain Indian oil, certain Alaskan oil and, in the case of qualified royalty owners, up to three barrels per day of royalty production, are exempt from the tax.

The windfall profit tax is scheduled to phase out over a 33-month period, beginning after December 31, 1987, if the cumulative revenue raised by the tax reaches $227.3 billion, but in any event begin-

ning no later than January, 1991. As of September 1986, $79 billion of windfall profit tax had been collected.

Proposals

Legislative proposals (S. 200, S. 255, and S. 846)

S. 200 (Senators Nickles, Bentsen, Dole, Wallop, and others), S. 255 (Senators Boren and Bingaman), and S. 846 (Senators Nickles and Wallop) would each repeal the crude oil windfall profit tax. The repeal in S. 255 and S. 846 would be effective for crude oil removed after the date of enactment, while that in S. 200 would be effective for crude oil removed after December 31, 1986.

DOE report

The DOE report includes repeal of the windfall profit tax as a possible tax option.

President's proposal

The President's proposal recommends repeal of the windfall profit tax, effective October 1, 1987.

Analysis

Revenues

One of the main arguments in favor of repealing the windfall profit tax is that at present price levels, the tax raises little or no revenue; yet producers must nevertheless incur the burdensome recordkeeping expenses associated with the tax. Based on the Congressional Budget Office's most recent forecast of petroleum prices, the windfall profit tax will raise little or no revenue over the next five years.

In response, it is argued that the price of oil is extremely volatile and that past attempts to predict future oil prices have been fraught with error.

Effect on exploration and production

Another argument for repealing the windfall profit tax is that it discourages exploration and production of domestic oil. The windfall profit tax is in effect a sales tax on domestic crude oil which cannot be passed on to the consumer since the price of petroleum is set by foreign producers who are not subject to the tax. As a result of the tax, high cost oil may not be produced, and exploration activities may be reduced. The disincentive effect of the windfall profit tax may be offset by the percentage depletion allowance which is, in effect, a tax subsidy based on sales (i.e., a negative excise tax). However, it is hard to justify a tax system which simultaneously encourages and discourages crude oil production.

In response, it is argued that the windfall profit tax minimizes adverse effects on exploration and development by setting high base prices and lower tax rates for newly discovered, incremental tertiary, heavy, and stripper well oil.

Oil price decontrol

In April of 1979, the Carter Administration announced that it would use its discretionary authority over oil prices to phase out price controls between June 1, 1979 and September 30, 1981. Members of Congress who favored price controls did not seek legislation against decontrol in return for Administration support of a tax on a portion of the profits attributable to decontrol. The Crude Oil Windfall Profits Tax Act of 1980 is a result of this compromise.

Repeal of the Crude Oil Windfall Profit Tax Act might breach the compromise reached in 1980. However, the inflation-adjusted price of oil is now less than half of what it was when the Crude Oil Windfall Profit Tax Act was enacted: this change in circumstances might justify repeal or modification of the Act.

2. Repeal of anti-transfer rule

Present Law

Independent producer stripper well oil attributable to a working interest in the property is exempt from the crude oil windfall profit tax (sec. 4994(g)). This exception does not apply to any proven property that was owned after July 22, 1981, by a person other than an independent producer, and subsequently transferred to an independent producer.

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop), and S. 846 (Senators Nickles and Wallop)

S. 233 and S. 846 would repeal the anti-transfer rule for purposes of the independent producer stripper well exemption, effective for crude oil removed after the date of enactment.

Analysis

When the Congress enacted the Crude Oil Windfall Profit Tax in 1980, an exemption was provided for independent producers stripper well oil. The anti-transfer rule was designed to prevent integrated producers from indirectly benefiting from the windfall profit tax exemption by selling proven stripper well properties to independent producers. Congress also was concerned that revenues from the tax could be reduced significantly by tax-motivated transfers of proven properties.

Repeal of the transfer rule would have little effect on exploration (since new oil is taxed at the same rate for both independent and integrated producers) and would do little to increase current production (since there is little or no windfall profit at current oil prices). Independent producers only would benefit from repeal of the anti-transfer rule on properties acquired from integrated producers if the price of oil increases above current levels.

3. Statute of limitations for certain underpayments of tax

Present Law

Except as provided in regulations, the windfall profit tax is withheld by the first purchaser of the oil from the price paid for the oil. The producer generally is required to file a return (Form 720) only if its windfall profit tax liability exceeds the amount of tax withheld during the calendar year. When required, Form 720 must be filed not later than May 31 of the next succeeding calendar year.[4]

If a producer is not required to file Form 720, the statute of limitations for assessment (or refund) of windfall profit tax runs three years from the due date of the producer's income tax return for the taxable year in which the removal year ends. If a Form 720 was filed, the limitation period runs for three years from the due date of that form.

In Rev. Rul. 85-37, 1985-1 C.B. 362, the IRS took the position that, if Form 720 was required to be filed (e.g., because of an underwithholding of windfall profit tax), but was not filed, the period for assessment is unlimited.

Proposal

S. 846 (Senators Nickles and Wallop)

Under S. 846, for statute of limitations purposes, the producer would not be treated as having been required to file a windfall profit tax return, if the amount of tax withheld by the first purchaser with respect to any oil was not less than the amount required to withheld as shown on the return filed by the first purchaser. Thus, in such cases, a three-year statute of limitations would apply, measured from the due date of the producer's income tax return.

This provision would be retroactive to the original effective date of the windfall profit tax.

Analysis

An unlimited assessment period generally is applied in cases where the IRS could not reasonably be expected to have notice of a taxpayer's failure to pay the correct amount of tax (e.g., in the case of failure to file a required return). Allowing a limited assessment period where no return was filed would be contrary to this policy. On the other hand, it may be argued that a producer who relied on the first purchaser's finding that no windfall profit tax was due should be treated in the same manner as a producer that was not required to file a return.

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[4] The first purchaser of oil is required to file quarterly returns of withheld tax, including information necessary to facilitate coordination of withholding by the purchaser with the determination of tax on the producer of the oil.

B. Income Tax Proposals

1. Proposals relating to drilling costs

a. Tax credit for drilling expenditures

Present Law

Intangible drilling and development costs generally

Costs incurred by an operator to develop an oil or gas property for production are of two types: (1) intangible drilling and development costs, and (2) depreciable costs. The acquisition price for the oil- or gas-producing property, and geological and geophysical costs are recovered through depletion deductions (see discussion below).[5]

Under present law, domestic intangible drilling and development costs ("IDCs") may either be currently expensed or else may be capitalized and recovered through depletion or depreciation deductions (as appropriate), at the election of the operator. In general, IDCs include expenditures by the property operator incident to and necessary for the drilling and the preparation of wells for the production of oil or gas (or geothermal energy) which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property.

IDCs include amounts paid for labor, fuel, repairs, hauling, supplies, etc., to clear and drain the well site, make an access road, and do such survey and geological work as is necessary to prepare for actual drilling. Other IDCs are paid or accrued by the property operator for the labor, etc., necessary to construct derricks, tanks, pipelines, and other physical structures used to drill the wells and prepare them for production. IDCs include amounts paid or accrued to drill, shoot, and clean the wells. IDCs also include amounts paid or accrued by the property operator for drilling or development work done by contractors under any form of contract.

Only persons holding an operating interest in a property are entitled to deduct IDCs. This includes an operating or working interest in any tract or parcel of oil- or gas-producing land either as a fee owner, or under a lease of any other form of contract granting working or operating rights. In general, the operating interest in an oil or gas property must bear the cost of developing and operating the property. The term operating interest does not include royalty interests or similar interests such as production payment rights or net profits interests.

Generally, if IDCs are not expensed, they can be recovered through depletion or depreciation, as appropriate. If IDCs are capitalized, costs paid or incurred with respect to a nonproductive well ("dry hole") may nonetheless be deducted as an ordinary loss, at the election of the operator, in the taxable year in which the dry hole is completed.

No tax credit is provided for IDCs or similar expenses under present law.

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[5] Amounts paid or accrued during the development of a property to acquire tangible property ordinarily considered to have a salvage value (e.g., tools, pipe, cases, tubing, engines, etc.) are recovered through depreciation deductions. No election is permitted with respect to these costs.

Thirty-percent reduction for integrated producers

In the case of a corporation which is an integrated oil company (i.e., which is not an independent producer) [6] the allowable deduction with respect to domestic IDCs is reduced by 30 percent. The disallowed amount must be added to the basis of the property and amortized over a 60-month period, starting with the month in which the costs are paid or accrued. Amounts paid or accrued with respect to nonproductive wells (dry hole costs) are fully deductible in the taxable year in which the nonproductive well is completed.

Treatment of foreign IDCs

Under a provision added by the Tax Reform Act of 1986, IDCs incurred with respect to properties located outside the United States do not qualify for expensing. Instead, these costs must be recovered (1) using 10-year, straight-line amortization beginning in the year paid or incurred, or (2) at the taxpayer's election, as part of the basis for purposes of any deduction allowable under section 611.[7]

Proposal

DOE report

The DOE report includes an option to provide a 5-percent income tax credit for all exploration and drilling expenditures. These would include intangible drilling and development costs and, additionally, geological and geophysical ("G&G") costs in connection with oil and gas properties (*see also,* II.B.3, below).

Analysis

An argument in favor of an oil and gas exploration tax credit is that the market may fail to generate a socially desirable level of investment in high risk and research-related activities. For example, the Code reflects this view by providing a 20-percent credit for increases in research and experimental expenditures.

In addition, some argue that the social cost of using oil exceeds its market price. The excess cost, or "premium", is attributable to the national security cost of oil use (including the cost of maintaining the strategic petroleum reserve), and the impact of increased U.S. petroleum consumption on the world petroleum market. Since the market price does not reflect the premium value of crude oil, according to this theory, domestic producers may fail to invest adequately in oil exploration. In this case, tax incentives for exploration and development may be desirable to achieve an adequate supply of petroleum.

Since a tax credit provides only a small benefit to taxpayers with little tax liability, it may be less efficient than a subsidy delivered through a direct spending program. In particular, given current oil prices, independent oil producers may receive relatively less benefit from the credit than integrated producers since, independents gen-

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[6] These terms are defined in the same manner as for purposes of percentage depletion (discussed in II.B.2.).

[7] *See,* the discussion of depletion, in II.B.2., below.

erate little or no income from refining or retailing operations. Also, independent producers benefit from full expensing of IDCs and the use of percentage depletion (although these benefits may be limited by the alternative minimum tax).

b. Recapture of IDCs and depletion

Present Law

When a taxpayer disposes of oil, gas, or geothermal property, a portion of the gain must be treated as ordinary income instead of capital gain (sec. 1254). For property placed in service on or after January 1, 1987, the amount subject to such "recapture" is equal to the lower of (1) the amount of IDCs deducted (which, but for being deducted, would have been reflected in the adjusted basis of the property), plus depletion deductions that reduce the adjusted basis of the property, or (2) the gain on the sale, exchange, or involuntary conversion of the property.

For property placed in service before January 1, 1986,[8] the recapture amount is equal to the lower of (1) the amount of IDCs deducted since January 1, 1976 (which, but for being deducted, would have been reflected in the adjusted basis of the property), reduced by the amount (if any) by which the depletion deduction with respect to such property would have been increased if such amounts had been capitalized, or (2) the gain on the sale, exchange, or involuntary conversion of the property. Thus, for such property, IDC (but not depletion) deductions are recaptured upon disposition of the property.[9]

Proposal

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

S. 233 would repeal the rules providing for recapture of intangible drilling cost deductions upon disposition of an oil, gas or geothermal property (sec. 1254). This repeal also would apply to the recapture of certain depletion deductions on property placed in service after 1986.[10]

This provision would be effective for dispositions of oil, gas or geothermal properties after the date of enactment.

Analysis

Under the Tax Reform Act of 1986, gain from the sale of oil, gas, and geothermal property attributable to deductions for intangible drilling costs and depletion allowances are treated as ordinary income rather than capital gain. Since ordinary income and capital gains are taxed at the same rate after 1987, the effect of the recapture rule is to prevent recapture income from being sheltered by

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[8] This rule also applies to property acquired pursuant to a binding, written contract in effect on September 25, 1985.

[9] Under the Tax Reform Act of 1986, the capital gain rate for individuals is conformed to the rates on ordinary income, effective in calendar year 1988. For calendar year 1987, a maximum 28-percent rate applies. The capital gain rate for corporations is 34 percent for gain recognized on or after January 1, 1987.

[10] The bill would not affect recapture of mining exploration and development costs (secs. 617(d) and 1254).

capital losses for taxpayers with net capital losses (or capital loss carryforwards).

Under the 1986 Act, the recapture rules for oil and gas property were made more similar to the rules applicable to depreciable property. S. 233 would afford oil and gas property more favorable recapture treatment than depreciable property—treatment that actually would be more beneficial to the taxpayer than the rules in existence before the 1986 Act.

c. Repeal of IDC minimum tax treatment

Present Law

IDC deductions on successful oil and gas wells are a tax preference item for purposes of the individual and corporate alternative minimum taxes, to the extent that the taxpayer's excess IDCs exceed 65 percent of the taxpayer's income from oil and gas properties. (Geothermal properties are treated in a similar manner.) Excess IDCs are defined generally as (1) IDC deductions (attributable to successful wells) for the taxable year, minus (2) the amount that would have been deductible in that year had the IDCs been capitalized and recovered over a 10-year, straight-line amortization period. At the election of the operator, the cost depletion method may be substituted for the 10-year amortization schedule in determining the amount of tax preference.

IDCs are not treated as a tax preference item if the taxpayer elects to amortize IDCs over a 10-year period.

Proposal

S. 846 (Senators Nickles and Wallop)

S. 846 would repeal the treatment of excess IDCs as a minimum tax preference item, effective for costs paid or incurred after the date of enactment.

Analysis

The alternative minimum tax enacted in the Tax Reform Act of 1986 requires that taxpayers pay a minimum rate of tax (21 percent for individuals and 20 percent for corporations) on a broad measure of their economic income. Repeal of the tax preference for excess IDCs would allow some producers to reduce their effective rate of tax below 21 or 20 percent (for individual and corporate taxpayers, respectively).

An argument in favor of the proposal is that it would increase the tax incentive for incurring drilling expenditures for producers that are subject to minimum tax. To the extent that repeal of the IDC preference allows producers to shelter most or all of their income from tax, however, other taxpayers may view the Tax Code as inequitable. Also, allowing an exception to the alternative minimum tax for the oil and gas industry might be a precedent for other industries seeking exceptions from the minimum tax.

d. Treatment of surface casing costs

Present Law

IDCs generally are limited to expenditures for items which do not have a salvage value (Treas. Reg. sec. 1.612-4(a)).

The Internal Revenue Service has ruled that, under present law, the cost of casing (including surface and production casing) and associated equipment must be capitalized and recovered through depreciation deductions, since the casing is deemed to have a salvage value.[11] Labor and other costs of installing the casing may be deducted as IDCs.

Proposal

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

Under S. 233, surface casing costs would be treated as IDCs for tax purposes, effective for costs paid or incurred after the date of enactment.

Analysis

Surface casing generally is installed only after the producer has determined that production from the well is commercially viable. Allowing surface casing costs to be expensed rather than capitalized would tend to encourage development of proven properties. Thus, the proposal probably would increase oil and gas production, but only would indirectly affect exploration activity.

A general tax policy principle is that the costs of acquiring or producing an asset with a useful life or more than one year should be capitalized rather than expensed. Under present law, an exception from this principle is made in the case of IDCs. The proposal would expand this exception, increasing the preferential tax treatment of the oil and gas industry relative to other sectors of the economy.

2. Proposals relating to depletion

a. Increase in percentage depletion rate

Present Law

General rules

Certain costs incurred prior to drilling an oil- or gas-producing property are recovered through depletion deductions. These include costs of acquiring the lease or other interest in the property, and geological and geophysical costs. Depletion is available to any person having an economic interest in a producing property (including a royalty interest).

Depletion is computed using whichever of two methods results in a higher deduction: cost depletion or percentage depletion.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of units sold from that property during the taxable year to the

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[11] *See*, Rev. Rul. 70-414, 1970-2 C.B. 132; Rev. Rul. 78-13, 1978-1 C.B. 63.

number of units remaining to be recovered at the beginning of the taxable year. The amount recovered under cost depletion cannot exceed the taxpayer's basis in the property.

Under percentage depletion, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted may not exceed 50 percent of the taxable income from the property for the taxable year, computed without regard to the depletion deduction (the "net income limitation"). Additionally, the deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions).[12] Because percentage depletion is computed without regard to the taxpayer's basis in a property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

Percentage depletion, to the extent it exceeds the adjusted basis of the property, is treated as a preference item for purposes of the individual and corporate alternative minimum taxes.

Limitation to independent producers, etc.

Under present law, percentage depletion for oil and gas properties is limited to independent producers and royalty owners[13] (as opposed to integrated oil companies), for up to 1,000 barrels of average daily domestic crude oil production, or an equivalent amount of domestic natural gas.[14] For producers of both oil and natural gas, this limitation applies on a combined basis.[15]

For purposes of percentage depletion, an independent producer is any producer who is not a "retailer" or "refiner." A retailer is any person who directly, or through a related person, sells oil or natural gas or any product derived therefrom (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person obligated to market or distribute such oil or natural gas (or product derived therefrom) under the name of the taxpayer or the related person. (Bulk sales to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are excluded for this purpose.) Further, a person is not a retailer within the meaning of this provision if the combined gross receipts of that person and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed $5 million for the taxable year.

A refiner is any person who directly or through a related person engages in the refining of crude oil, but only if such taxpayer or related person has a refinery run in excess of 50,000 barrels per day on any day during the taxable year.

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[12] Amounts disallowed as a result of this rule may be carried forward into later taxable years.

[13] Under a provision added by the Tax Reform Act of 1986, percentage depletion is not available for lease bonuses, advance royalties, or other amounts paid without regard to actual production from a property.

[14] As originally enacted, the depletable oil quantity was 2,000 barrels of average daily production; however, this was phased down to 1,000 barrels for 1980 and thereafter.

[15] Certain regulated natural gas, natural gas sold under a fixed contract, and natural gas from geopressured brine is exempt from the 1,000 barrel per day limitation.

Similar depletion rules apply to geothermal deposits located in the United States, except that the 1,000-barrel-per-day and 65 percent of taxable income limitations do not apply to such deposits.

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

S. 233 would increase the percentage depletion rate for crude oil and natural gas, if the taxpayer's average removal price for oil and gas sold during the calendar year is $20 per barrel or less. The amount of the increase would depend upon the average annual removal price, as shown in the following table:

*If the average annual removal price during the calendar year is:**	*The applicable percentage is:*
Less than $10	30 percent
$10 to $15	25 percent
$15 to $20	20 percent
Greater than $20	15 percent

*These prices are measured in dollars per barrel.

The "average annual removal price" for the taxpayer would be determined by dividing the taxpayer's aggregate production of domestic crude oil or natural gas for the calendar year by the aggregate amount for which such production was sold.[16] In the case of crude oil or natural gas sold between related persons, removed before sale, or refined on the production premises, a constructive sales price would be used (secs. 613 and 4988(c)). For example, if a taxpayer sold 100,000 barrels of crude oil for an aggregate price of $1.8 million in calendar year 1988, the taxpayer's average removal price would be $18 per barrel, and a percentage depletion rate of 20 percent would apply to all production by that taxpayer in 1988.

Percentage depletion would continue to be limited to 1,000 barrels per day of domestic crude oil production (or an equivalent amount of natural gas) by independent producers.[17] Additionally, the limitation on percentage depletion deductions for all oil and gas properties, to 65 percent of the taxpayer's overall taxable income, would remain in effect.[18]

The changes in the percentage depletion rate would be effective for production during calendar years beginning after December 31, 1986.

S. 846 (Senators Nickles and Wallop)

S. 846 would provide a 27.5-percent depletion rate with respect to a taxpayer's domestic new, enhanced, or stripper production, as defined under the bill. This deduction would be available to all taxpayers (including independent and integrated producers), for an un-

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[16] The legislation apparently intends that the average annual removal price be determined by dividing removal production in barrel-of-oil equivalents into (rather than by) the amount for which such production was sold.

[17] The bill would repeal the anti-transfer provisions for purposes of this limitation (see discussion in II.B.2.c., below).

[18] The 50-percent net income limitation would be repealed under S. 233, as described in II.B.2.c., below.

limited amount of production; however, it would be limited to 100 percent [19] of net income from the property and 100 percent [20] of the taxpayer's adjusted taxable income. Additionally, as under the independent producer exception, percentage depletion would not be available for lease bonus or advance royalty payments.

For purposes of the bill, new production would include production from any property (as defined for percentage depletion purposes) that commences production after March 31, 1987. Enhanced production would include (1) the increase in average daily production for the taxable year over average daily production for the period January 1, 1987, through March 31, 1987, and (2) incremental tertiary oil as defined for windfall profit tax purposes (sec. 4993(a)). Stripper production would include production from any stripper well property as defined in the June 1979 energy regulations.

This provision would be effective for production during the taxpayer's first full taxable quarter following the date of enactment.

DOE report

The DOE report includes two options to increase the percentage depletion rate for oil and gas properties:

(1) Higher percentage depletion for independent producers and royalty owners.—Under this option, percentage depletion for oil and gas properties would continue to be available only to independent producers and royalty owners, for a maximum of 1,000 barrels per day of production. However, the percentage depletion rate for such properties would be increased, from 15 to 27.5 percent.

(2) Higher percentage depletion for new production.—This option would allow all taxpayers (including independent and integrated producers) to take percentage depletion on an unlimited amount of new domestic oil and gas production, at a 27.5-percent rate. To limit the increase in deductions that would result from higher prices, the report suggests the possibility of a sunset provision, under which present-law rules would be restored if oil prices exceeded a specified level for a 12-month period.

Analysis

Under S. 233, the rate of percentage depletion for oil and gas would be increased from 15 percent to 30 percent as the average annual removal price of oil falls from $20 to $10 per barrel. The effect is to increase the rate of percentage depletion when the income of domestic producers falls due to declining world oil prices. Other proposals (S. 846 and the DOE report) would increase the percentage depletion rate under specified circumstances.

An argument in favor of a variable rate of percentage depletion is that it would tend to stabilize the income of oil and gas producers. This provision is similar to certain agriculture stabilization programs which increase payments to farmers when farm income falls as a result of oversupply. However, such a policy would tend to destabilize the world petroleum market by encouraging domestic

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[19] This would replace the present-law 50-percent limitation under S. 846 (*see*, II.B.2.c., below).
[20] This would replace the present-law 65-percent limitation under S. 846 (*see*, II.B.2.c., below).

production when the world market is confronted by a glut. This could make it more difficult for the major oil-importing countries to coordinate energy policies.

Increasing the rate of percentage depletion would provide little or no benefit to many of the oil and gas producers hardest hit by falling petroleum prices: those producers with net operating losses. Additional depletion deductions have no immediate value to producers without income tax liability. Increasing the rate of percentage depletion on oil produced from existing wells would encourage more rapid depletion of these reservoirs, but would not encourage additional oil and gas exploration activity.

b. Repeal of anti-transfer rule

Present Law

Percentage depletion for oil and gas properties is limited to independent producers, for up to 1,000 daily barrels of oil production (or an equivalent amount of natural gas).

To prevent proliferation of the independent producer exception, all production owned by businesses under common control, or by members of the same family, must be aggregated for purposes of these rules. Further, if an interest in a proven oil or gas property is transferred after 1974, production from such interest does not qualify for percentage depletion. Exceptions to this anti-transfer rule are provided in the case of transfers at death, to controlled corporations, and between controlled corporations or certain other business entities.

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

S. 233 would repeal the anti-transfer provision for purposes of the 1,000 barrel per day limitation on percentage depletion. Thus, proven oil and gas properties could be transferred to an independent producer and qualify for percentage depletion. Percentage depletion would continue to be limited to 1,000 barrels of average daily production by each transferee (including production from transferred and other properties).

The repeal of the percentage depletion anti-transfer rule would be effective for production after the date of enactment, in taxable years ending after that date.

S. 846 (Senators Nickles and Wallop)

S. 846 would repeal the percentage depletion anti-transfer provision, effective for transfers taking place after the date of enactment.

DOE report

The DOE report includes an option to repeal the percentage depletion anti-transfer rule. It suggests that, in order to limit the transfer of more profitable properties, repeal of the anti-transfer rule could be restricted to stripper wells.

President's proposal

The President's proposal recommends repeal of the percentage depletion anti-transfer provision.

Analysis

Since 1975, the use of the percentage method for computing depletion deductions for oil and gas wells has been restricted to independent producers and royalty owners for limited amounts of crude oil and natural gas.

At the time these restrictions were enacted, Congress recognized that taxpayers would attempt to maximize the amount of oil and gas eligible for percentage depletion by transferring ownership interests. Consequently, the 1975 Act specifies that the limitation on the amount of oil and gas eligible for percentage depletion is to be computed by aggregating the production of related parties. In addition, the 1975 Act generally disallows percentage depletion with respect to transfers of proven oil and gas property.

The anti-transfer rules prevent integrated producers from indirectly obtaining the benefits of percentage depletion by selling productive oil and gas property to independents. The anti-transfer rules also prevent independent producers with less than 1,000 barrels per day of average production from buying proven reserves in order to use up their percentage depletion limitation.

An argument for repeal of the anti-transfer rule is that by expanding the amount of oil and gas eligible for percentage depletion, the Tax Code would provide a more powerful incentive for production, and might prevent the abandonment of marginal wells that otherwise would be permanently closed. Oil and gas exploration activities also would be expected to increase as a result.

An argument against repeal of the anti-transfer rules is that integrated producers would be able to benefit indirectly from percentage depletion by selling reserves to independents. A substantial portion of the revenue loss attributable to this provision would result from the transfer properties that are already developed, rather than the transfer of newly-discovered oil and gas properties.

c. Repeal of or increase in net income and 65 percent limitations

Present Law

Percentage depletion deductions with respect to an oil, gas, or hard mineral property may not exceed 50 percent of the taxable income from the property for the taxable year (the "net income limitation"). Additionally, the deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions). Amounts disallowed under this latter rule may be carried forward to later taxable years.

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

S. 233 would repeal the 50 percent of net income limitation on percentage depletion deductions for oil and gas properties. Thus, percentage depletion would equal the specified percentage of gross income from each property, without regard to the net income from that property. The overall limitation to 65 of adjusted taxable income would continue to apply.

The repeal of the net income limitation would be effective for taxable years beginning after the date of enactment.

S. 846 (Senators Nickles and Wallop)

S. 846 would increase the 50 percent of net income limitation to a 100-percent limitation, for oil and gas properties only. Under this rule, percentage depletion with respect to an oil or gas property could not exceed 100 percent of taxable income from the property for the taxable year (i.e., the deduction could be used to offset taxable income from the property, but could not offset other income).

The bill would also increase the limit on percentage depletion for all oil and gas properties, to 100 percent (rather than 65 percent) of the taxpayer's adjusted taxable income.

These provisions would each be effective for taxable years beginning after the date of enactment.

DOE report

The DOE report includes an option to increase the net income limitation on oil and gas properties from 50 to 100 percent.

President's proposal

The President's proposal would increase the net income limitation from 50 to 100 percent.

Analysis

The percentage depletion allowance can be viewed as a tax rate reduction. The 50-percent of net income limitation acts to limit the rate reduction to 50 percent of the otherwise applicable income tax rate. For example, where production costs are zero, percentage depletion reduces the tax rate of a 28-percent bracket taxpayer (not subject to alternative minimum tax) to 23.8 percent (85 percent of 28 percent). As production costs rise, the tax rate is reduced from 85 percent of the otherwise applicable tax rate to 50 percent of such tax rate (for production costs at or above 70 percent of gross oil and gas income).[21]

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[21] Consider a 28-percent tax bracket producer with $100 of gross income from oil and gas properties and zero production costs. In this case, net oil and gas income is $100 ($100 of gross income less zero production cost), the percentage depletion deduction is $15 (15 percent of $100), taxable income is $85 ($100 less $15), tax liability on oil and gas income is $23.80 (28 percent of $85), and the effective tax rate is 23.8 percent ($23.80 as a percent of $100 of net income). If production costs are $70, net oil and gas income is $30 ($100 of gross income less $70 of production cost), the percentage depletion deduction is $15 (15 percent of $100), taxable income is $15 ($30 less $15), tax liability on oil and gas income is $4.20 (28 percent of $15.00), and the effective rate is 14 percent ($4.20 as a percent of $30 of net income).

An argument for repealing or modifying the 50-percent of net income limitation is that it effectively eliminates the benefit of percentage depletion for producers who have little or no net income from oil and gas properties as a result of high exploration or production costs. Repeal of the net income limitation would allow percentage depletion deductions to be used against income from non-oil and gas activities, thus providing a potential benefit to producers without net oil and gas income. (Increasing the limitation to 100 percent would not benefit producers without net income from oil and gas properties.)

An additional argument for repealing or modifying the 50-percent limitation is that the alternative minimum tax and passive loss rules provided by the Tax Reform Act of 1986 may be sufficient to prevent excessive use of percentage depletion deductions to shelter income unrelated to oil and gas activities.

The 65-percent limitation acts to limit the sheltering of oil and gas income by unrelated tax losses. For a taxpayer subject to the 65-percent limitation, each dollar of tax loss from activities outside the oil and gas business reduces the taxpayer's percentage depletion deduction by 65 cents, resulting in a net shelter of 35 cents of oil and gas income.

An argument for repealing or modifying the 65-percent limitation is that the alternative minimum tax and passive loss rules provided by the Tax Reform Act of 1986 may be sufficient to prevent excessive use of unrelated tax losses against oil and gas income.

Another argument for repealing or modifying both the 65-percent and 50-percent limitations is that a producer subject to either limitation may have a tax incentive *not* to incur exploratory costs since such costs, in effect, only are partially deductible. This situation arises because each dollar of deductible expense (e.g., exploratory costs) reduces the percentage depletion deduction by 50 cents for a taxpayer at the 50-percent limit, and 65 cents for a taxpayer at the 65-percent limit. Increasing the limitations (for example to 100 percent) would, in effect, make exploratory costs 100-percent nondeductible for taxpayers subject to limitation.

These proposals, by reducing the tax rate on oil and gas income, favor the oil and gas industry over other sectors of the economy, such as agriculture and manufacturing. This may harm the long-run competitiveness of the U.S. economy. In addition, since oil and gas reserves are a finite resource, encouraging production now will reduce domestic supplies in the future.

3. Proposals relating to geological and geophysical ("G&G") costs

a. Faster recovery for G&G costs

Present Law

Under present law, geological and geophysical (G&G) expenditures for the purpose of identifying and locating productive mineral properties must be capitalized and recovered through depletion deductions. These may include expenditures for reconnaissance surveys over a broad area, and more detailed surveys within an identified area of interest. G&G costs may be deducted as an ordinary

business loss (sec. 165) if the entire area of a survey is abandoned as a potential source of mineral production.[22]

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

Under S. 233, domestic (including U.S. possessions) G&G costs would be treated in the same manner as intangible drilling and development costs (IDCs) for tax purposes. Thus, these costs would qualify for expensing at the election of the operator, subject to a 30-percent reduction for integrated oil companies.[23]

S. 846 (Senators Nickles and Wallop)

S. 846 would treat domestic (including U.S. possessions) G&G costs in the same manner as IDCs, effective for costs paid or incurred after the date of enactment.

DOE report

The DOE report includes an option to treat domestic G&G costs in the same manner as IDCs.

Analysis

Under present law, G&G costs generally are recovered less rapidly than IDCs, since IDCs are not required to be capitalized and recovered through depletion deductions. Moreover, G&G costs may not reduce the tax liability of a producer using the percentage depletion method, because percentage depletion deductions are computed without regard to cost basis.

The relatively less generous tax treatment of G&G costs relative to IDCs may be viewed as inequitable. Moreover, to the extent that G&G activity and exploratory drilling are substitutable methods for finding oil and gas reserves, the less favorable treatment of G&G costs relative to IDCs may bias exploration activity against G&G surveys. Expensing of G&G costs would reduce this tax bias against G&G activity.

An argument against expensing of G&G costs is that, under the uniform capitalization rules of the Tax Reform Act of 1986, taxpayers are required to capitalize most costs attributable to the production of inventory property and long-term construction contracts. Expensing of G&G costs would provide significantly more favorable tax accounting treatment to the oil and gas industry than other sectors of the economy.

b. Tax credit for G&G costs

Present Law

No tax credit is provided for G&G costs.

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[22] *See*, Rev. Rul. 77-188, 1977-1 C.B. 76; Rev. Rul. 83-105, 1983-2 C.B. 51.

[23] The minimum tax rules applicable to IDCs also would apply to these costs.

Proposal

DOE report

The DOE report includes an option to provide a 5-percent income tax credit for G&G expenditures.[24]

Analysis

For an analysis of the issued involved in establishing a tax credit for exploratory and drilling expenditures, see the discussion in II.B.1.a., above.

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[24] The report also includes an alternative option to provide a 5-percent credit for all exploration and drilling expenditures (*see*, II.B.1.a., above).

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